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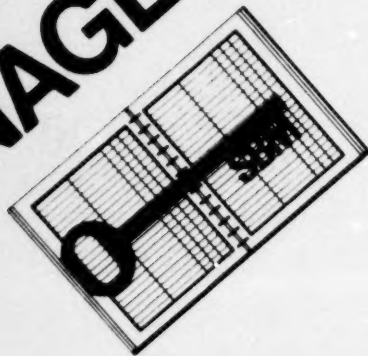
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## ABSTRACT

A supplement to a previous volume (CE 009 649), this document contains handouts, case problems, schedules, and seminar information keyed to specific units of instruction. The contents by year and unit areas are as follow: year I, unit 1--time management (two-page handout concerning four problems to avoid; year I, unit 2--warranty register (a sample register for use in businesses that sell goods covered by warranty); year I, unit 3--accounts payable schedule; year I, unit 6--bank reconciliation (a worksheet combining bank balance, checkbook balance, and ledger balance); year I, unit 7--accounts receivable (a handout to be used in a discussion of credit and collection); year I, unit 7, sources and uses of cash (outline of the sources and uses of cash); year I, unit 10--human needs (a handout concerning human needs in reference to employee wants); year I, unit 12--tax management (a handout showing the choices and advantages of different business decisions); year I, unit 12--tax planning (a description of tax planning and its implications); year II, unit 10--economic versus accounting profit (a brief case describing the differences between economic versus accounting profits); and year II, unit 10--financial analysis worksheet (a balance sheet analysis form for use in evaluating the business position). (JH)

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# SMALL BUSINESS MANAGEMENT



ED167765

## ADDENDUM TO SMALL BUSINESS MANAGEMENT EDUCATION CURRICULUM VOLUME III

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**AN ADULT  
EDUCATIONAL  
PROGRAM**

CE 020 019

ADDENDUM TO SMALL BUSINESS MANAGEMENT  
CURRICULUM VOLUME III

Project Directors: Edgar Persons, Ph.D.  
Gordon Swanson, Ph.D.

Project Staff: Dwight Hyle  
Rodger Palmer, Ph.D.  
Patti Hollern

Consultant: Craig Schauffert

Division of Agricultural Education  
University of Minnesota  
St. Paul, Minnesota  
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Steve Miller, Don Jonson, Gary Schmidt, George Berg, Bill Helgen, Bill Tweetie, Marv Bollum, Jim Maino and Fred Rice.

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## INTRODUCTION

This addendum is a supplement to the original Volume III - Curriculum. It contains handouts, case problems, schedules and seminar information pertinent to specific units of instruction. This information has been developed and utilized by individual small business management education instructors to support existing units. It is not meant to replace the unit to which it is keyed, only to give added resources to a certain business topic. However, individual instructors may insert these materials in their own instructional plan as they see fit.

# Time Management

## FOUR STUMBLING BLOCKS TO AVOID

To gain the objective of a much more productive day, you are going to have to fight off these four major roadblocks. If you do not plan your strategy well, they will win and you will find yourself running out of time.

### ROADBLOCK ONE: INDOLENCE

Indolence is one of man's basest traits. The indolent mind and body atrophies and feeds upon itself.

One can hardly be only indolent -- the trait heaps upon itself equally bad characteristics, like rotting flesh draws flies. For one, the lazy person is selfish; there is so much to do for so many reasons, yet all these things are put aside for the sake of doing as little as possible. The indolent man is ignorant, with all the social ills that involves, because learning -- from others and by experience -- requires effort. He is often a frightened man, refusing to face life, avoiding it by all costs. And laziness begets indifference, one of the monstrous evils of all times, especially in these times.

Indolence is a constant threat to most people -- those it has already conquered -- but it is defeated by the will which will lead the way.



### ROADBLOCK TWO: PROCRASTINATION

Procrastination is a form of wishful thinking, and we all indulge in it, but it is a time-consuming activity and must be reduced to a minimum if we are to get more things done.

Actually, procrastination does not principally involve time allotment at all, but merely the desire to avoid an unpleasant task altogether.

We also lose time in "make ready" and "put away" when we procrastinate. We must use up valuable time in reorienting our minds to the problem at hand each time we take it up anew. Once is enough!

### ROADBLOCK THREE: DIVERSION

Diversion is no less an enemy than indolence when it comes to getting things done, although it is a little less insidious. It seems that the more active the mind and the more broad



the fields of interest, the more diversions there are. Certainly, broad interests are desirable, but they should be entertained under conditions which will not detract from one's basic objective.

Most of us in our daily lives are in conflict with diversions such as socializing with callers, becoming over-involved in fruitless personality situations, watching other people at work and so on. Try to eliminate as many of these as possible.

#### ROADBLOCK FOUR: IMPATIENCE

Impatience is a surrender, often to emotions. It's just easier to let oneself become annoyed or bored than to apply a studied reason.

Impatience for many people is a by-product of a lack of self-confidence. Under trying conditions we can retreat behind a veil of impatience without consciously declaring ourselves inept. Where the situation is particularly trying, anger crowns our impatience to provide us a denser smoke screen to cover our headlong retreat.

Boredom is still another facet of impatience. It is always blamed on external sources -- a bad speaker, a wait for the dentist with nothing to do but read old magazines, the same old people with their same old words. But boredom really comes from within and is an expression of our own limitations.

Refuse to be bored! There is too much to do (and too little time) to be bored!





YEAR 1 1951 3  
OF 10000

5

19

12

Month \_\_\_\_\_ 19\_\_\_\_

| OUTSTANDING CHECKS |         |        |         | CHECKBOOK RECONCILIATION          |          |
|--------------------|---------|--------|---------|-----------------------------------|----------|
| Number             | Account | Number | Account |                                   |          |
|                    |         |        |         | Balance Per Checkbook.....        | \$ _____ |
|                    |         |        |         | Less:                             |          |
|                    |         |        |         | Bank Charges.....                 | \$ _____ |
|                    |         |        |         | Direct Credit Payments.....       | _____    |
|                    |         |        |         | .....                             | _____    |
|                    |         |        |         | .....                             | _____    |
|                    |         |        |         | .....                             | _____    |
|                    |         |        |         | NSF Checks.....                   | _____    |
|                    |         |        |         | TOTAL Subtractions.....           | \$ _____ |
|                    |         |        |         | Plus:                             |          |
|                    |         |        |         | Loans.....                        | \$ _____ |
|                    |         |        |         | .....                             | _____    |
|                    |         |        |         | TOTAL Additions.....              | \$ _____ |
|                    |         |        |         | *Corrected Checkbook Balance..... | \$ _____ |
|                    |         |        |         | Remarks:                          |          |
|                    |         |        |         |                                   |          |
|                    |         |        |         |                                   |          |
|                    |         |        |         |                                   |          |

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## THOSE #Z\*&amp;%@!/ ACCOUNTS RECEIVABLES!

1. John Smith was not a regular customer of the Dole Hardware store, but the owner of the small store knew him by sight and civic reputation. One day, Mr. Smith came into the store and purchased a \$200 television set from Mr. Dole.

"These new portable sets are so lightweight that I'll just take it with me in the car," said Mr. Smith. "I'll send you a check for it."

"That will be fine," Mr. Dole agreed.

Sixty days later, after sending two unanswered statements to the buyer, Mr. Dole decided to turn the Smith account over to a collection agency for action.

Please answer the following questions based on the above information:

- a. Did a contract exist between Mr. Smith and Mr. Dole for the television transaction? Yes ☐ No ☐
- b. Why?
- c. Was Mr. Smith's account past due? Yes ☐ No ☐
- d. Why?
- e. Did Mr. Dole follow sound and logical procedures in attempting to collect this account? Yes ☐ No ☐
- f. Would you have handled it differently? Yes ☐ No ☐
- g. If you answered yes to question "f" above, outline what you would have done.
- h. Were both parties in error on this transaction? Yes ☐ No ☐
- i. Why?
2. What is the standard length of time allowed for payment on charge sales in today's market?
3. For income tax purposes, accounts receivables are not considered taxable income until the account is paid. True ☐ False ☐

4. Once an account receivable is officially written off from your records and deducted as a bad debt, it is no longer legal to collect this account for your business. True \_\_\_\_ False \_\_\_\_
5. Many businesses encourage people to charge. True \_\_\_\_ False \_\_\_\_

## Key Question 1. Sources of Cash

## I. Capital or Equity

- a. Owners Investment
  - 1) Savings
  - 2) Sales of stocks or bonds
  - 3) Inheritance or gifts
  - 4) Sales of real estate or personal property
- b. Partner or Partners
- c. Stockholders
- d. Profit through business - once business is in operation

## II. Creation of the Liability - Borrowing

Loans and their repayment should be matched to the use of money, i.e. short term borrowing for current asset use, inventory, and accounts receivable should be repaid by the sale of that asset. Long term borrowing should have repayment schedule matched with depreciation and will be repaid from profits.

- a. Banks
- b. Friends and Relatives
- c. Finance Companies
- d. Insurance Companies
- e. SBA
- f. Vendors - vendors don't provide cash but will provide things which can be used as cash: Inventory, co-op ads, warranty claims.

## III. Sale of Assets Returned to Cash

- a. Inventory - should be sold at a profit - might be necessary to just get investment back.
- b. Accounts Receivable - may be sold immediately or returned to cash by agreed on terms.
- c. Fixed Assets

## Key Question 2. Uses of Cash

## I. Purchases of Assets

- a. Inventory
- b. Accounts Receivable
- c. Fixed Assets
  - 1) Land
  - 2) Equipment
  - 3) Furniture and Fixtures
  - 4) Buildings
  - 5) Vehicles

II. Reduction of a Liability - Repayment of Debt

III. Owners Draw or Distribution of Profits

IV. Operating Expenses

- a. Wages
- b. Utilities
- c. Insurance and Interest
- d. Advertising
- e. Maintenance of Assets
- f. Taxes, Supplies, Etc.

## HUMAN NEEDS

- |                                                   |                      |
|---------------------------------------------------|----------------------|
| 1. Basic survival needs (food, water, air, sleep) | Limited, economic,   |
| 2. Safety, security                               | external             |
| 3. Love, affection, social activity               |                      |
| 4. Esteem, self respect, human dignity            | Unlimited, symbolic, |
| 5. Self realization, accomplishment               | internal             |

Each level of need must be met before the next level will dominate. Needs are expressed in a work situation by employee wants and then become motivators.

## TYPICAL EMPLOYEE WANTS

1. Good leadership - decision, action
2. Information - where do I stand, what is happening in business
3. To be treated as adults
4. Opportunity for growth and development
5. Freedom and independence
6. Positive social contact - avoid conflict
7. Security - safety - we will resist change
8. Comfort - working condition and pay
9. Useful work, feeling of achievement, recognition
10. Fair treatment

## I. Introduction

## II. Objectives

- A. What are basic motives?
- B. How are they applied in day to day work situations?

## III. Small Groups

- A. List top five motives - why people work
- B. Report to group
  - 1) List
  - 2) Categorize - define need

## IV. How do basic human needs translate into what the employee wants from his job?

- A. Difference between need and want
  - 1) Need - Inner drive, what makes people tick
  - 2) Want - Expression of need in a given environment when a need is converted into a want it becomes a motivator
- B. What do employees want? What do you want?
  - 1) List
  - 2) Categorize
  - 3) What things in business provide wanted 1-10, discuss

## V. Management's job is to identify the needs and wants of employees and activate an appropriate incentive toward task accomplishment (find and push the GO button). What is the motivation process - MBO

- A. List steps and discuss
  - 1) Objective
  - 2) Emphathize
  - 3) Integrate
  - 4) Communicate
  - 5) Assist
  - 6) Coordinate
  - 7) Alter
- B. Direction of motivation
  - 1) External - reward, punishment
    - a) Needs 1 & 2
    - b) Economic in nature
    - c) Temporary
    - d) I Y D I W
  - 2) Internal - attitude, desire
    - a) Needs 3, 4 & 5
    - b) Symbolic
    - c) Longer term
    - d) Inner satisfaction, recognition, feels good

## VI. Summary - comment, Bud Grant, Vince Lombardi communicate - people will try to do what you want

## MOTIVATION PROCESS

1. Determine your objective
2. Look at objective in terms of your employee's needs
3. Find how employee's wants can be satisfied by your objective
4. Communicate your objective and plan - listen to response
5. Remove roadblocks - provide assistance
6. Coordinate activities of group
7. Alter motivation to meet changing conditions

## DIRECTIONS OF MOTIVATION

## I. External - Reward, Punishment

- A. Works only with needs 1 & 2
- B. Economic in nature
- C. Short term
- D. "If you don't ... I will," "If you do ... I will"

## II. Internal - Attitude, Desire

- A. Works with needs 3, 4 & 5
- B. Symbolic
- C. Long term
- D. Inner satisfaction, recognition, feels good

Management's job is to find and push the GO button.

I KNOW THAT  
YOU BELIEVE YOU  
UNDERSTAND WHAT  
YOU THINK I SAID,  
BUT  
I AM NOT SURE  
YOU REALIZE THAT  
WHAT YOU HEARD  
IS NOT  
WHAT I MEANT.

Area of Tax Management

## Legal Form of Business

Choices

Proprietorship  
Partnership  
Corp./Sub. Chapter S

Advantages

Individual rate  
Partners can deduct losses  
No corporate tax

## Purchases of Equipment

Leasing  
Investment credit  
Bonus depreciation  
Accelerated depreciation  
Straight line depreciation

Deduct lease payments  
10% of cost  
20% of cost  
Higher deduction in first years  
Spread depreciation out

## Sale of Assets

Capital gains  
Installment

Tax on  $\frac{1}{2}$  of income  
Spread income out

## Method Of Accounting

Cash  
Accrual  
Hybrid

Recording income and expenses to  
fit the cycles of your business

## Retirement Plan

HR/10 - Keogh

Postpone tax

SOME TAX PLANNING CONSIDERATIONS  
FOR THE SMALL BUSINESS

Prepared and Presented by:  
JACOB K. CLIFTON, JR.  
101 East Broadway, Suite 200  
Eugene, Oregon

## I N D E X

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## ATTACHMENTS:

INCOME TAX ESTIMATE WORKSHEET

CHART ON §1231 TREATMENT

This outline is intended to be used in connection with the 1977 edition of Internal Revenue Service Publication 334 "Tax Guide for Small Business". References will be made to Publication 334 as well as to the Internal Revenue Code and applicable regulations as appropriate.

This presentation and the accompanying materials are in no way intended to be a complete summary of tax considerations for small business persons, but rather are intended to highlight some possible advantages that can be attained through careful tax planning. Although particular attention is directed to late year planning tactics, tax planning should be a full-time consideration in the operation of any business large or small.

The discussion is directed only to Federal Income Taxes.

## II. PREDICTING YOUR TAX OBLIGATION

Although you should always be cognizant of your perhaps unwilling partnership with the taxing authorities, particular emphasis should be attached to your tax burdens toward the end of the taxable year. For calendar year taxpayers, now is an ideal time to address these problems, but of course the same considerations apply to fiscal year taxpayers at appropriate intervals.

Predicting your tax obligation, like all other aspects of running a business, is an inexact science and you should not expect precise answers. Use of the schedule on the following page should at least assure that you consider all the proper variables.

Naturally, in extending the "amount to date" column to the the "estimated year's total" column, a straight percentage extrapolation may not be appropriate. You are in the best position to estimate the cyclical nature of your business and if earnings are dramatically higher or lower during the last two months of the taxing period your extrapolations should reflect this variation.

The attached worksheet is based on the law that applies to calendar year 1977 and is intended for use by a sole proprietorship. Naturally, the law may change from year to year and the worksheet will, therefore, become obsolete. A corporate taxpayer will have essentially the same problems to consider, but some of the inclusions and deductions are by nature inapplicable to such a taxpayer.

### III. ASSET -ACQUISITIONS AND LATE YEAR TAX PLANNING

Although spending money may at first appear to be a strange approach to saving money, it may be possible to substantially reduce your tax obligation through investments in business equipment. In some cases, it is possible to acquire new assets without any appreciable cash outflow after the tax advantages are considered.

#### ADDITIONAL FIRST YEAR DEPRECIATION ALLOWANCE FOR SMALL BUSINESS

The first item to be discussed is the Additional First Year Depreciation Allowance For Small Business afforded by section 179 of the Internal Revenue Code. This provision is also discussed on pages 46-48 of Publication 334.

In summary, a business (whether a sole proprietorship, partnership, or corporation) may elect to take an additional deduction equal to 20% of the cost of "Section 179 Property." Section 179 Property is defined in §179(d) of the Code and on page 47 of Publication 334 to be personal property used in your trade or business of a character subject to the allowance for depreciation which is acquired by purchase after December 31, 1957 and which has a useful life of six years or more.

Although the benefits of §179 are available to any business, the limitations of §179(b) make it significant only to small businesses. A business may only make a §179 election for assets with a total value of \$10,000, or \$20,000 in the case of a joint return, with corporations operating under the \$10,000 limitation. Notice that the limitation applies to the cost of the property and not to the amount of the credit so that the limitation of \$10,000 on the property is the same as a limitation of \$2,000 on the credit.

Section 179 is elective and although generally it is desirable, there may be circumstances in which it is preferable to pass up the election. Taking the additional first-year depreciation will have the effect of lowering depreciation deductions in subsequent years and will also require recapture of the depreciation if the property is later sold at a price in excess of its basis (this aspect of the problem is discussed more fully in part IV following). Therefore, if taxable income is already minimal in the year of acquisition but it is anticipated that it will be higher in subsequent years, it may well be desirable to pass up the additional depreciation in the first year.

Notice that the 20% additional depreciation is allowable any time the asset is placed in service during the tax year and is not prorated for partial years. Therefore, the same additional depreciation is allowable whether the asset is put in use in January or December, but of course the tax

benefits are more immediately realized in the latter case.

### INVESTMENT TAX CREDITS

The Investment Tax Credit provided by §38 and §§46-48 of the Internal Revenue Code are discussed on pages 142 through 149 of Publication 334. The ITC is intended to stimulate economic growth by encouraging investments in productive assets and is one of the most important tax benefits extended to businesses. The provisions dealing with investment tax credit are far more complex than those dealing with additional first year depreciation and only a brief discussion will be included at this point.

First of all, the property must qualify as "Section 38 Property" which is defined in §48(a) of the Internal Revenue Code and discussed on pages 142 and 143 of Publication 334. Again, the benefits are restricted to tangible, personal property used in a trade or business which is subject to an allowance for depreciation and again the useful life of the equipment is critical. However, unlike the useful life rule contained in §179 the statute on Investment Tax Credit phases in the benefits with no benefit available for assets with a useful life of less than 3 years and maximum benefits available for assets with a useful life of 7 or more years. These rules are discussed on page 144 of Publication 334 and in §46 of the Internal Revenue Code.

Under some circumstances, it is possible to get the benefits of the Investment Tax Credit even though you are leasing the property rather than purchasing it. Among other things, the Lessor must agree to allowing you the credit and the Internal Revenue Service must receive verification of this agreement.

Unlike the additional first year depreciation provided by §179, taking the investment tax credit does not affect the basis of the property or reduce later depreciation deductions and need not be recaptured on ultimate disposition of the asset unless it is disposed of before the end of the useful life used in the original computation. In short, the investment tax credit will always work to the advantage of the taxpayer and the carry forward provisions make it advantageous even if the credit exceeds the tax liability for the year.

As with §179, there are limits on the investment tax credit, but they are far higher than the limits imposed by §179 and probably will not apply to most who consider themselves "small business people."

Again, you may claim full benefit for the investment tax credit even if the property is acquired on the last day of the taxable year so it lends itself to late year tax planning.

## ILLUSTRATION

For hypothetical purposes consider a small manufacturing business which reports its income on schedule C of a joint Federal Income Tax Return and assume that the taxpayers predict that their total taxable income for 1977 would be \$47,200. Under §1(a) of the Internal Revenue Code as now in effect. The tax on this income would be \$14,060 and the taxpayers would be in the 50% marginal tax bracket. The tax would of course be due on April 15, 1978, although in most cases the taxpayers would have made substantial prepayments.

Suppose further that the business could utilize a new piece of depreciable equipment with a 7 year useful life and a cost of \$20,000 and that financing is available for 80% (\$16,000) of this purchase price. If this asset were purchased in December, 1977, the taxpayers could claim additional first-year depreciation equal to 20% or \$4,000 which would represent a \$2,000 tax savings at the 50% tax rate. In addition, the taxpayers would be entitled to an Investment Tax Credit equal to 10% of the cost or \$2,000 for a total tax savings of \$4,000. This tax savings would be almost immediately available to the taxpayers and would be equal to the downpayment on the hypothetical facts. In effect, the taxpayers have achieved 100% financing on this new acquisition.

## CAVEAT

In this area, as in others, it is easy to make the mistake of allowing tax considerations to dominate your thinking and to ignore other important factors. Although the tax savings are important, obviously none of this makes sense unless the business in fact can make use of the new assets and this business judgment must be made before the acquisition.

## IV. ASSET DISPOSITION AND LATE YEAR TAX PLANNING

This section is devoted to the disposition of assets used in the trade or business, including in some cases real estate. In more specific terms, it is directed towards "Section 1231 Assets" which are defined in §1231(b) of the Internal Revenue Code and also discussed on page 113 of Publication 334. Please notice that the 6 month holding period described in Publication 334 is erroneous and should be 9 months for the present year and 12 months for future years.

Before we get into the potential planning advantages in disposing of §1231 property, it is first necessary to discuss depreciation recapture which unfortunately does not lend itself to planning. Depreciation recapture is provided by §1245 of the Internal Revenue Code in the case of personal property and in §1250 of the Internal Revenue Code in the case of real property. These provisions are discussed on pages 89 and 90 of Publication 334.

Since depreciation deductions go to reduce ordinary income, in some instances Congress has considered it appropriate to require any subsequent gain on sale of the depreciable asset to be recovered at ordinary income rates rather than at the advantageous capital gains rates which would otherwise apply. For reasons that are both practical and political a different set of rules applies to real estate than applies to personal property. In working in this area you or your advisors must also keep a close eye on the effective date of the statute. For purposes of these discussions, I will assume that all assets involved were acquired after 1969, but in some cases property acquired prior to that time may be subject to different rules.

Gramatically, the statutes are quite complex, but the accompanying graphs should help you understand them. Notice that in the case of personal property, all gain attributable to previous depreciation will be subject to recapture at ordinary income rates whereas in the case of real property, only the element of gain attributable to accelerated depreciation will be recaptured at ordinary income rates. In some cases, after a sufficient holding period the real property basis will begin to "heal" itself and the recapture problem will disappear, but a discussion of this is beyond the scope of tonight's presentation.

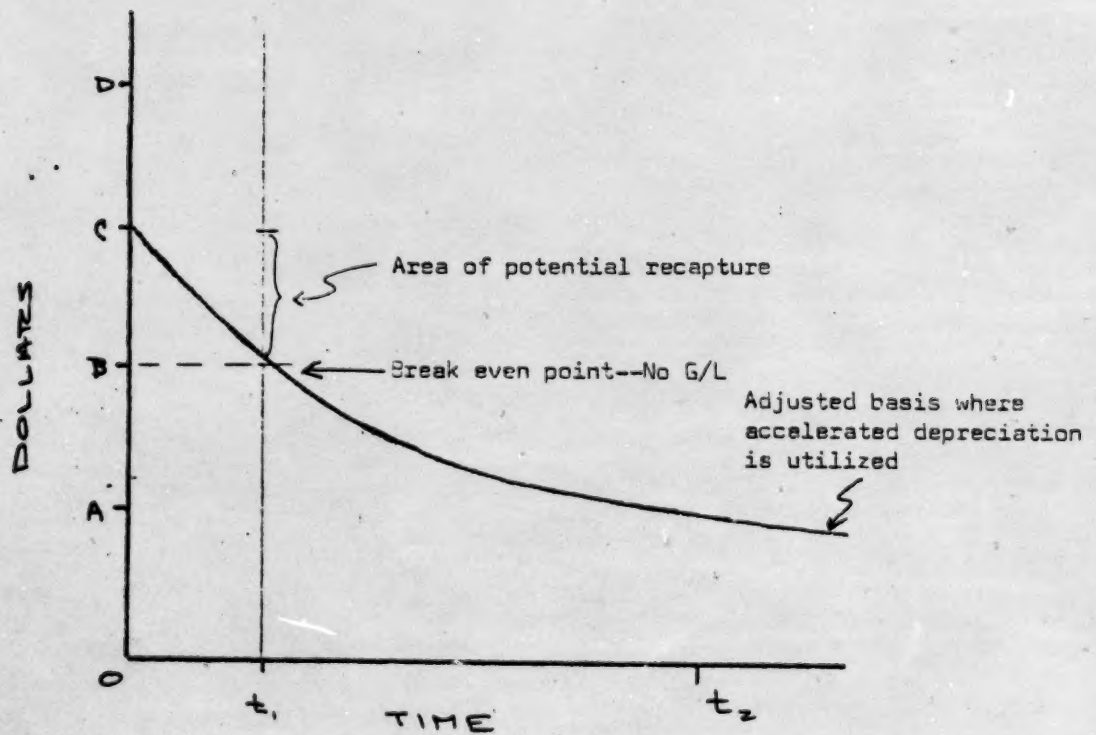
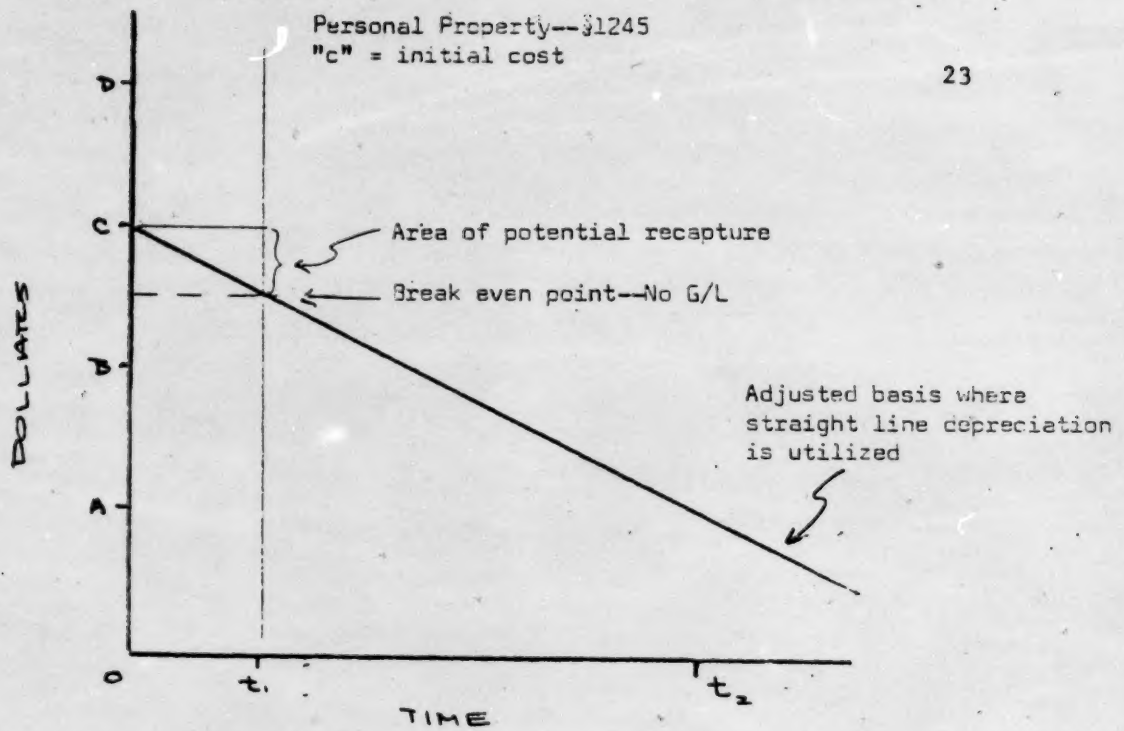
Also, please notice that if the asset is disposed of at a loss (that is, the amount realized on the disposition is less than the adjusted basis) the recapture rules are inapplicable.

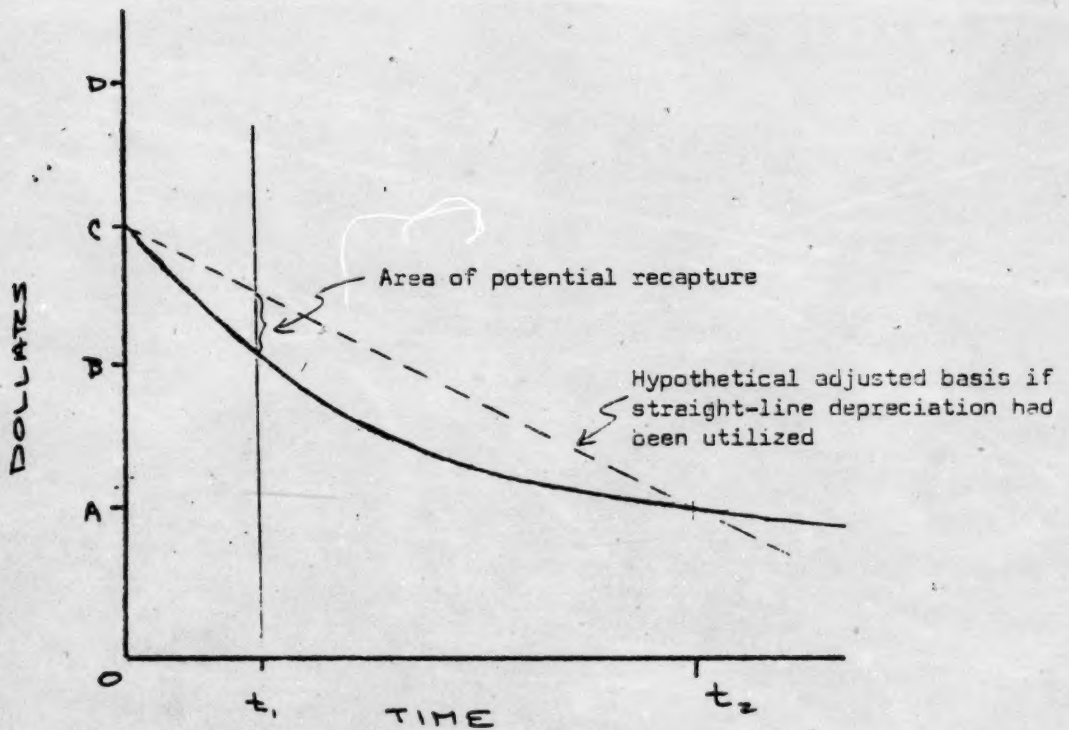
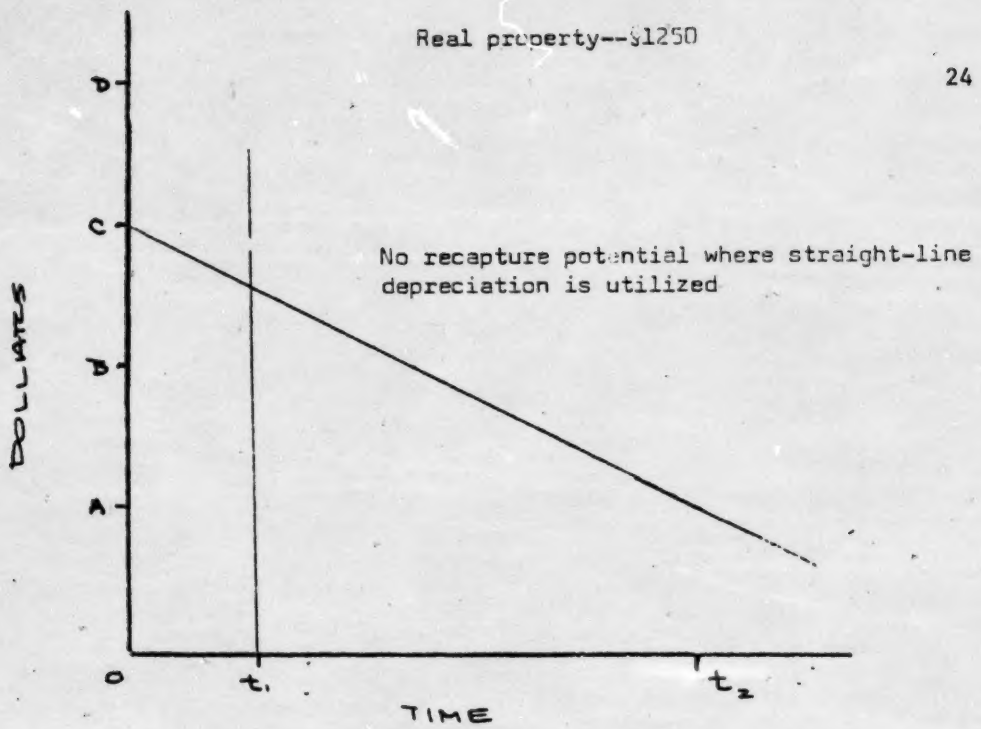
The first set of graphs applies to personal property subject to §1245 with the top graph illustrating the situation where straight line depreciation is utilized and the lower graph illustrating the situation in which some form of accelerated depreciation is utilized. In either case, if the asset is disposed of at a price greater than the adjusted basis, but less than C, the original cost, the gain will all be treated as ordinary income subject to recapture. If the asset is disposed of at a price higher than C, the difference between C (the recomputed basis) and the sales price will be treated as §1231 gain and potentially subject to capital gains benefits.

The second set of graphs illustrates a parallel situation with real property rather than personal property. Once again, the solid lines illustrate the adjusted basis of the property where straight line depreciation is utilized and where some form of accelerated depreciation is utilized. Notice that in the lower graph there is a dotted line indicating the basis as it would exist if straight line

Personal Property--§1245  
"c" = initial cost

23





depreciation had been utilized. Where straight line depreciation is utilized, there is no recapture of depreciation but where accelerated depreciation is utilized there is a potential recapture problem to the extent that the depreciation deductions claimed under the method used exceed the depreciation deductions which would have been allowable had straight line depreciation been utilized.

#### GAIN OR LOSS NOT WITHIN THE SCOPE OF §1245 or §1250

Although the gain subject to recapture is treated as ordinary income, any other gain will be subject to the rules of §1231 as will any loss on the disposition of §1231 assets. Recall that in the case of personal property §1231 gain will be generated only if the asset is disposed of for more than the original cost whereas in the case of real property §1231 gain will be generated if the asset is disposed of for an amount higher than the basis (real or hypothetical) if the asset were subject only to straight line depreciation.

While capital gains are generally a desirable form of income, capital losses are an undesirable form of loss. For reasons which are more historical than logical, our tax code grants the best of both worlds to the disposition of §1231 assets with gains taxed as capital gains but losses taken as a deduction against ordinary income. However, this general rule does not apply to each asset, but rather to the net result of dispositions during any taxable period. Once again, the statute is unusually complex and perhaps could be better understood with the aid of the attached chart or by looking at form 4797 upon which gains or losses of §1231 assets are reported.

Since it is usually possible to predict with some accuracy the potential gain or loss in an asset, and since it is also possible to control the time of disposition, it is clearly possible to manipulate the netting effect of §1231. For illustration purposes, let us return to the hypothetical tax return discussed earlier showing taxable income of \$47,200. Let us further assume that the business has disposed of no other assets during the year and in November of 1977 has a small building which it no longer needs and which will generate a gain of approximately \$10,000 on disposition and a piece of equipment which it no longer needs that will generate a loss of approximately \$5,000 on disposition. Finally assume that the taxpayer predicts taxable income during 1978 comparable to that during 1977 and that the tax laws do not change during this period.

If the taxpayer disposes of both assets during 1977 and both are subject to §1231, the net effect will be the inclusion of a \$5,000 capital gain in 1977 which will effectively increase taxable income by \$2,500 leading to a total tax liability of \$15,310. Assuming that there are no dispositions in 1978 and a total tax liability of \$14,060, the tax liability for the two-year period will be \$29,370.

Suppose instead that the taxpayer disposes of the equipment during 1977 but delays disposition of the building until January, 1978 (perhaps renting it to the potential buyer during the interim). Now the taxpayer will have a \$5,000 ordinary deduction for 1977, lowering taxable income to \$42,200 giving rise to a Federal Income Tax of \$11,690. For 1978, there would be a \$10,000 capital gain which would have the effect of raising taxable income to \$52,200 resulting in a total Federal Income Tax of \$16,560. Under this second set of assumptions, the combined Federal Income Taxes for the two-year period would be \$28,250 for a tax savings of \$1,120.

#### V. WHEN TO INCORPORATE

From a tax point of view, it is a relatively simple and painless procedure to incorporate a business enterprise, either a new business or an existing business. On the other hand, getting rid of a corporation can be both complicated and expensive so the decision to incorporate should not be taken lightly.

Corporate tax rates can provide a valuable tax shelter for a growing business which requires reinvestment of most of its income. Under the current rates, a corporation is taxed at 20% of its first \$25,000 of taxable income, 22% of the next \$25,000 of taxable income, and 48% thereafter. An unmarried individual on the other hand is taxed on 21% on any amounts over \$6,200 and reaches the 50% bracket at approximately \$34,200. This suggests that from a tax point of view, a single individual with a highly profitable business would be well advised to incorporate it, pay himself a salary of approximately \$6,000, allow the next \$50,000 of taxable income to remain in the corporation, pay himself bonuses of up to approximately \$28,000 on corporate income in excess of \$50,000 and allow all remaining income to remain in the corporation. As a practical matter this, of course, would probably be impossible and one cannot ignore the problems of ultimately getting the money back out of the corporation although these are not insurmountable.

The situation which you should be careful to avoid is continually paying taxes at high rates on income which you must necessarily reinvest in the business rather than spending on your own pleasure or on some other enterprise. The advantages extended to corporate taxpayers are specifically intended to encourage capital formation and business growth and it is a mistake for you not to take advantage of them in the appropriate situation.

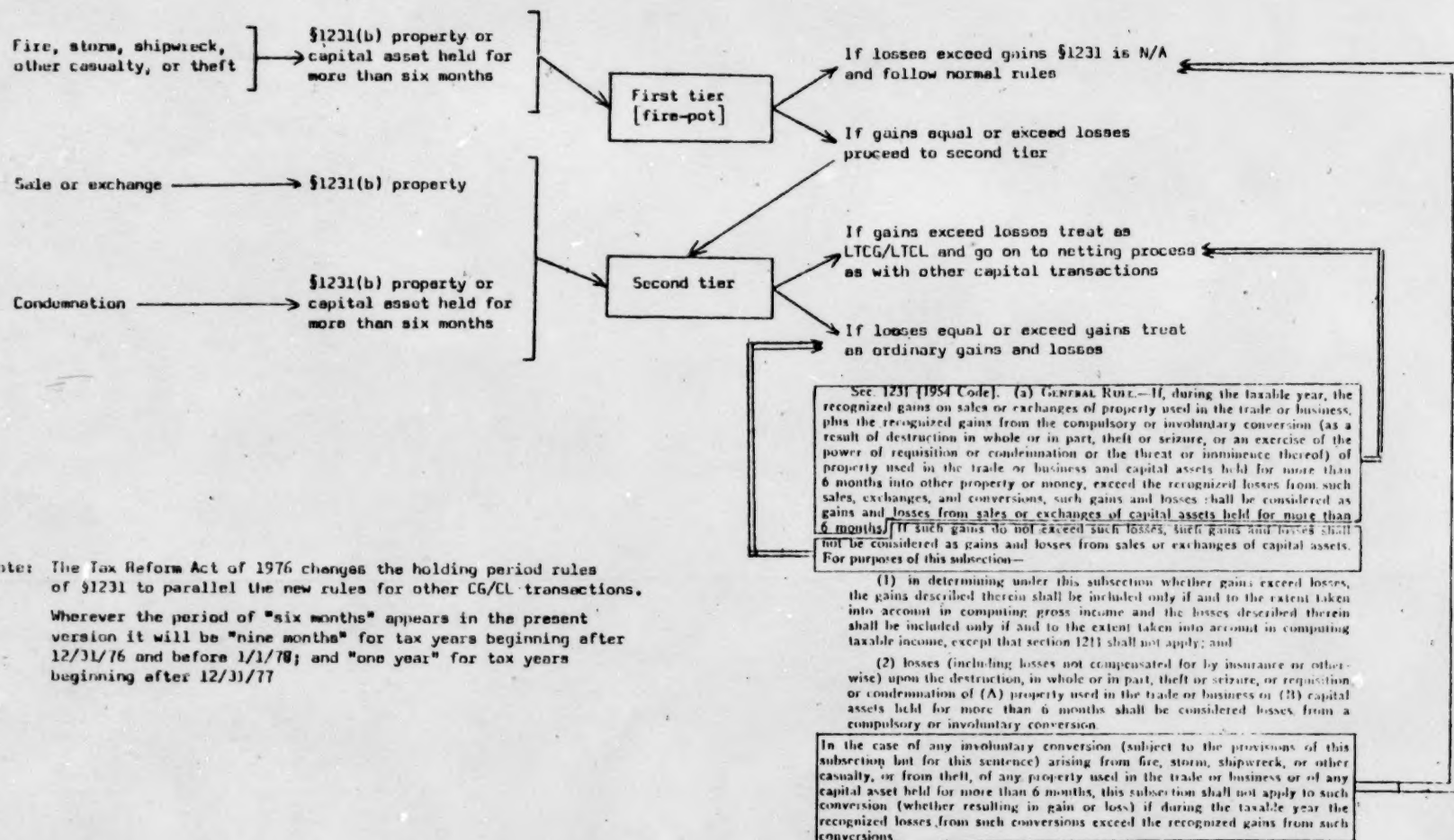
Apart from the advantageous tax rates and the possibility of splitting income between two taxpayers (i.e., yourself and your corporation) there are tax advantages to being an employee of your own corporation. The best known of these is the possibility of a deferred compensation plan but others, such as extended fringe benefits will be discussed briefly.

As you know, there are several non-tax reasons which might encourage a small business person to incorporate (primarily limited liability in both tort and contract). Under the rules of Subchapter S (discussed at pages 137-141 of Publication 334), it is possible in most circumstances to obtain the non-tax advantages of corporate status without coming under the tax rules which apply to most corporations. A Subchapter S election is particularly valuable during the early period of a corporation when it is generating little taxable income or perhaps even losses which are better used on the owner's personal returns than on the corporation's returns.

## EVENT

## PROPERTY

## §1231 TREATMENT



Note: The Tax Reform Act of 1976 changes the holding period rules of §1231 to parallel the new rules for other CG/CL transactions.

Wherever the period of "six months" appears in the present version it will be "nine months" for tax years beginning after 12/31/76 and before 1/1/78; and "one year" for tax years beginning after 12/31/77

## INCOME TAX ESTIMATE WORKSHEET

|                                                                                                              | AMOUNT<br>TO DATE | ESTIMATED<br>REST OF<br>YEAR | ESTIMATED<br>YEAR'S<br>TOTAL |
|--------------------------------------------------------------------------------------------------------------|-------------------|------------------------------|------------------------------|
| <b>RECEIPTS:</b>                                                                                             |                   |                              |                              |
| 1. Gross Receipts                                                                                            | ( )               | ( )                          | ( )                          |
| 2. Cost of Goods Sold                                                                                        | ( )               | ( )                          | ( )                          |
| 3. Gross Income                                                                                              |                   |                              |                              |
| <b>BUSINESS EXPENSES:</b>                                                                                    |                   |                              |                              |
| 4. Payroll, employees total earnings                                                                         |                   |                              |                              |
| 5. Rent                                                                                                      |                   |                              |                              |
| 6. Repairs to equipment, etc.                                                                                |                   |                              |                              |
| 7. Operating supplies                                                                                        |                   |                              |                              |
| 8. Taxes and licenses                                                                                        |                   |                              |                              |
| 9. Interest                                                                                                  |                   |                              |                              |
| 10. Telephone, light, power, heat, water                                                                     |                   |                              |                              |
| 11. Advertising                                                                                              |                   |                              |                              |
| 12. Insurance                                                                                                |                   |                              |                              |
| 13. Gas, Oil, Grease                                                                                         |                   |                              |                              |
| 14. Legal                                                                                                    |                   |                              |                              |
| 15. Other expenses                                                                                           |                   |                              |                              |
| 16. Contributions and other deductions                                                                       |                   |                              |                              |
| 17. Total cash business expenses                                                                             |                   |                              |                              |
| 18. Depreciation                                                                                             |                   |                              |                              |
| 19. Total deductions (item 17 + 18)                                                                          |                   |                              |                              |
| 20. Self employment business income (item 3 less item 19)                                                    |                   |                              |                              |
| 21. Net taxable gain from Schedule D                                                                         |                   |                              |                              |
| 22. Taxable non-business income                                                                              |                   |                              |                              |
| 23. Adjusted gross income (item 20 + 21 + 22)                                                                |                   |                              |                              |
| 24. Less larger of "0 bracket income" or itemized ded.)                                                      |                   |                              |                              |
| 25. \$750 x _____ personal exemptions                                                                        |                   |                              |                              |
| 26. Total non-business deductions & exemptions (item 24 + item 25)                                           |                   |                              |                              |
| 27. Taxable income (item 23 less item 26)                                                                    |                   |                              |                              |
| 28. Estimated income tax (calculated from applicable tax computation table or rates)                         |                   |                              |                              |
| 29. Estimated self-employment tax (item 20 x current rate)                                                   |                   |                              |                              |
| 30. TOTAL TAX (item 28+item 29)                                                                              |                   |                              |                              |
| 31. Less credits: allowable investment credit & carryover, gas tax, income tax withhold & estimated tax paid |                   |                              |                              |
| 32. Estimated tax due (item 30 less item 31)                                                                 |                   |                              |                              |

NOTE: This worksheet does not provide any computation for the minimum tax which may also be a factor.

## ECONOMIC PROFIT VS. ACCOUNTING PROFIT

The concept of economic profit is often misunderstood, and it is frequently confused with the term BUSINESS or ACCOUNTING PROFIT. The net income or net loss shown on the accountant's income statement is simply the difference between the total income of the business and its total expenses in a given period. The accountant lists only the explicit costs of doing business. (Explicit = Clearly stated costs) These costs consist of the actual payments of cash or of bookkeeping entries for the expense accounts, such as wages, material, and depreciation. In order to find the true economic profit, the economist will consider any implicit cost that may be involved. (Implicit = Costs not clearly stated) These costs will consist of allowances for the use of the owner's own factors of production, such as labor, land or capital that are used in the input mix. They do this in order to reduce any income to a true economic profit.

As an example, let us assume that there are two gas stations with identical plant facilities located catercornered to each other, one selling Zip gasoline and the other Pep. Assume further that the entrepreneur of the Zip station, Mr. Zipper, rents his station, borrows the money to buy his inventory, and hires a manager to operate the station; and that the entrepreneur of the Pep station, Mr. Pepper, uses his own funds to buy his station and to finance his inventory, and manages the station himself. If their sales were identical for a given period, their respective income statements may appear as follows:

| Zip Service Station<br>Income Statement |                  | Pep Service Station<br>Income Statement |                  |
|-----------------------------------------|------------------|-----------------------------------------|------------------|
| Net Sales                               | \$120,000        | Net Sales                               | \$120,000        |
| Cost of Goods Sold                      | <u>90,000</u>    | Cost of Goods Sold                      | <u>90,000</u>    |
| Gross Profit on Sales                   | \$ 30,000        | Gross Profit on Sales                   | \$ 30,000        |
| Operating Expenses:                     |                  | Operating Expenses:                     |                  |
| Rent                                    | \$ 4,800         | Wages                                   | \$ 6,000         |
| Wages                                   | 6,000            | Insurance                               | 300              |
| Salary                                  | 7,500            | Depreciation                            | 800              |
| Insurance                               | 300              | Other                                   | 500              |
| Interest                                | 400              |                                         |                  |
| Other                                   | 500              |                                         |                  |
| Net Income                              | <u>\$ 10,500</u> | Net Income                              | <u>\$ 22,400</u> |

At first glance it appears that the Pep Service Station is making more than double the profit that Zip is making. A closer look at the figures, however, reveals that the economic profit of the two firms may be identical. Notice that Mr. Zipper paid out a specific rent of \$4,800, a manager's salary of \$7,500 and interest of \$400 on his loan. These, along with the others, are explicit costs of doing business and the accounting profit of \$10,500 in this case will correspond to the true economic profit from operating the business.

In the case of the Pep Service Station, however, the business profit of \$22,400 is not the true economic profit. Certain implicit costs must be computed.

Since Mr. Pepper is working as manager in his own service station, this use of his own services is a cost of doing business. The imputed value of his service can be determined by calculating what he could earn in a similar job working for someone else. This is known as Opportunity Cost. Specifically, opportunity cost can be measured by determining what amount of income a factor of production could earn if used in a similar or the next best capacity elsewhere.

In this case, it is readily determinable that Mr. Pepper could probably have earned at least \$7,500 per year managing another gas station, if the salary Mr. Zipper is paying to his manager indicates a reasonable salary for that type of work.

Likewise, assume that Mr. Pepper has borrowed \$8,000, paying 5 percent interest in order to finance his inventory. This means that his money tied up in inventory could have been earning at least \$400 per year invested elsewhere. Therefore, it is costing him \$400 in opportunity interest to use his own money in the business. The opportunity rent can be determined by calculating the net rent that could be earned by renting the building to someone else. In this case assume he could rent the station for \$4,800, the same rent Mr. Zipper was paying. However, since the depreciation cost of the building is \$800 per year, the implicit net rental income from the station would be \$4,000. Thus, implicit net rental income plus the depreciation charge is equal to the gross rental income of \$4,800 which is equivalent to the rent paid by Mr. Zipper. Now if we were to add these imputed costs totaling \$11,900 to the operating expenses of the Pep Service Station, the total operating expenses would increase from \$7,600 to \$19,500 and it would show the same economic profit as the Zip Service Station, \$10,500.

Is this to say that the Pep Service Station did not earn \$22,400? No, not at all. It is merely saying that of the \$22,400 total earnings, only \$10,500 can be attributed to profits. The remainder is earned from the use of the other factors of production. Another way to look at the situation is to say that the Zip Service Station had a business income of \$10,500 which was all economic profit. On the other hand, the Pep Service Station, or Mr. Pepper in particular, had a business income of \$22,400, but it should be allocated as follows: \$7,500 as salary income, \$4,000 as net rental income, \$400 as interest income, and \$10,500 as economic profit.

This is a very important distinction in economic analysis. Many entrepreneurs especially those operating small businesses, are misled because they lack an understanding of the true nature of economic profits. Suppose, for example, that the gross profit on sales of the Pep Service Station fell to \$15,000. Deducting the operating expenses as shown in the preceding income statement, \$7,600 would leave a business profit of \$7,400. Mr. Pepper might think that

his business is doing well since it shows a \$7,400 business profit. Actually the business is operating at an economic loss. If he subtracts his imputed costs, he would have the following breakdown of his \$7,400 business income: salary, \$7,500; rental income, \$4,000; interest income, \$400; and an economic loss, \$4,500. His business is not making a profit at all but is suffering a loss. If the situation continues, he would do better economically to sell his station, reinvest his money in bonds, and go to work for someone else.

Source: Economics, Hailstones-Brennan, 2nd Edition

FINANCIAL ANALYSIS WORKSHEET

| Acct # | Account Name                 | Last Month | This Month | Change + Or - | Beginning Of Year | Year to Date | Change + Or - |
|--------|------------------------------|------------|------------|---------------|-------------------|--------------|---------------|
| 101    | Cash - Bank                  |            |            |               |                   |              |               |
| 102    | Petty Cash                   |            |            |               |                   |              |               |
| 108    | Accounts Receivable          |            |            |               |                   |              |               |
| 120    | Inventories                  |            |            |               |                   |              |               |
| Dept 1 |                              |            |            |               |                   |              |               |
| Dept 2 |                              |            |            |               |                   |              |               |
| Dept 3 |                              |            |            |               |                   |              |               |
| Dept 4 |                              |            |            |               |                   |              |               |
| Dept 5 |                              |            |            |               |                   |              |               |
| Dept 6 |                              |            |            |               |                   |              |               |
| Dept 7 |                              |            |            |               |                   |              |               |
| Dept 8 |                              |            |            |               |                   |              |               |
| Dept 9 |                              |            |            |               |                   |              |               |
| TOTAL  | Inventory                    |            |            |               |                   |              |               |
| 179    | Total Current Assets         |            |            |               |                   |              |               |
| 181    | Land                         |            |            |               |                   |              |               |
| 182    | Buildings                    |            |            |               |                   |              |               |
| 183    | Acc. Dep. Buildings          |            |            |               |                   |              |               |
| 184    | Equipment & Fixtures         |            |            |               |                   |              |               |
| 185    | Accm. Dep. Equip. & Fixtures |            |            |               |                   |              |               |
| 186    | Vehicles                     |            |            |               |                   |              |               |
| 187    | Accm. Dep. Vehicles          |            |            |               |                   |              |               |
| 188    | Organization Cost            |            |            |               |                   |              |               |
| 189    | Ammort. Organization Cost    |            |            |               |                   |              |               |
| 190    | Total Fixed Assets           |            |            |               |                   |              |               |
| 41     | Total Assets                 |            |            |               |                   |              | 42            |

## FINANCIAL ANALYSIS WORKSHEET

| Acct # | Account Name            | Last Month | This Month | Change + Or - | Beginning of Year | Year to Date | Change + Or - |
|--------|-------------------------|------------|------------|---------------|-------------------|--------------|---------------|
| 208    | Accounts Payable        |            |            |               |                   |              |               |
| 213    | Floor Plan              |            |            |               |                   |              |               |
| 214    | Floor Plan              |            |            |               |                   |              |               |
| 215    | Floor Plan              |            |            |               |                   |              |               |
| 216    | Note Payable - Bank     |            |            |               |                   |              |               |
| 217    | Note Payable - Other    |            |            |               |                   |              |               |
| 218    |                         |            |            |               |                   |              |               |
| 219    |                         |            |            |               |                   |              |               |
| 220    | Federal Wh & FICA Pay   |            |            |               |                   |              |               |
| 221    | State Wh Payable        |            |            |               |                   |              |               |
| 222    | Federal Unemp. Pay      |            |            |               |                   |              |               |
| 223    | State Unemp. Pay        |            |            |               |                   |              |               |
| 224    | Sales Tax Pay           |            |            |               |                   |              |               |
| 225    |                         |            |            |               |                   |              |               |
| 226    |                         |            |            |               |                   |              |               |
| 250    | Total Current Liability |            |            |               |                   |              |               |
| 261    | Mortgage Payable        |            |            |               |                   |              |               |
| 262    | Intermed. Loan Pay      |            |            |               |                   |              |               |
| 263    |                         |            |            |               |                   |              |               |
| 295    | Total Fixed Liability   |            |            |               |                   |              |               |
| 229    | Total Liabilities       |            |            |               |                   |              |               |
| 310    | Capital                 |            |            |               |                   |              |               |
| 319    |                         |            |            |               |                   |              |               |
| 320    | Drawing -               |            |            |               |                   |              |               |
|        | Profit to Date +        |            |            |               |                   |              |               |